TABLE 2. ESTIMATED REVENUE EFFECTS OF CHANGES IN TAX EXPENDITURES IN THE ECONOMIC RECOVERY TAX ACT OF 1981, FISCAL YEARS 1981-1986 (In millions of dollars)

Change	1981	1982	1983	1984	1985	1986
New Tax Expenditures						
Safe-harbor leasing	-439	-2,649	-3,614	-5,065	-6,732	-8,512
Deduction for two-earner married couples	---	-419	-4,418	-9,090	-10,973	-12,624
Credit for increasing research activities	---	-448	-708	-858	-847	-485
Amortization of motor-carrier operating rights	-21	-121	-71	-71	-54	-18
Exclusion of interest on certain savings certificates	---	-398	-1,791	-1,142	---	---
Net interest deduction	---	---	---	---	-1,124	-3,126
Reinvestment of dividends in stock of public utilities	---	-130	-365	-416	-449	-278
Deduction for certain adoption expenses	---	-9	-9	-10	-11	-12
Suspension of regulations relating to allocation under Section 861 of research and experimental expenditures	---	-57	-120	-62	a	---
Exclusion for employer-provided child care	b	b	b	b	b	b
Industrial development bonds (IDBs) for mass transit	---	c	-7	-29	-54	-64
Increases in Tax Expenditures						
Child and dependent care credit	---	-19	-191	-237	-296	-356
Charitable contributions deduction for non-itemizers	---	-26	-189	-219	-681	-2,696
Rollover period for sale of residence	d	e	e	e	e	e
Increased exclusion on sale of residence	d	-18	-53	-63	-76	-91
Changes in taxation of foreign earned income	---	-299	-544	-563	-618	-696
Accelerated cost recovery system	-1,064	-6,920	-13,182	-21,185	-30,553	-44,285
Corporate rate reductions	---	-116	-365	-521	-565	-610

(Continued)

a. Less than $5 million.

b. Included in child and dependent care credit.

TABLE 2. (Continued)

Change	1981	1982	1983	1984	1985	1986
Credit for rehabilitation expenditures	-9	-129	-208	-240	-302	-414
Credit for used property	-24	-61	-74	-85	-137	-198
Charitable contributions of scientific property used for research	a	a	a	a	a	a
Commercial bank bad debt deduction	---	-15	-15	---	---	---
Extension and modification of targeted jobs tax credit	---	-63	-13	+57	+117	+161
Incentive stock options	a	a	a	a	+11	+21
Individual retirement savings	---	-229	-1,339	-1,849	-2,325	-2,582
Self-employed plans	---	-56	-157	-173	-183	-201
Employee stock ownership plans	---	a	-61	-627	-1,548	-2,298
Group legal service plans	---	-16	-24	-26	-8	---
Tax-exempt bonds for volunteer fire departments	---	c	c	c	c	c
Charitable contributions by corporations	---	-44	-93	-102	-112	-123
Amortization of construction period interest and taxes	---	-14	-33	-27	-23	-21
Amortization of low-income housing rehabilitation expenditures	-1	-8	-16	-25	-35	-39
		Reductions in Tax Expenditures				
Repeal of $200 exclusion of interest and return to $100 dividend exclusion	---	+566	+1,916	---	---	---
Tax straddles	+37	+623	+327	+273	+249	+229
Total	-1,521	-11,075	-25,417	-42,355	-57,331	-79,318

SOURCE: General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Joint Committee on Taxation, December 31, 1981.

c. Less than $1 million.
d. Negligible
e. Less than $10 million.

97-362) contained a provision expanding the definition of shale oil equipment for purposes of the energy investment tax credit which was estimated to result in an increase in the energy credit tax expenditure of less than $5 million in fiscal year 1983 and nothing in later years. In another bill, now Public Law 97-328, the Congress amended the District of Columbia Self-Government and Governmental Reorganization Act to allow the issuance of tax-exempt revenue bonds to finance college student loan programs. This provision is estimated to increase tax expenditures by less than $5 million a year.

No other changes in tax expenditures were finally enacted prior to the Congress' recess on October 2. All changes in tax expenditures enacted during calendar year 1982 will be reflected in the tax expenditure estimates for fiscal years 1983-1988, which will be prepared early next year.

CHAPTER III. CONTROLLING TAX EXPENDITURES THROUGH THE BUDGET PROCESS

The growth in tax expenditures in recent years and the need to make substantial reductions in future federal deficits have combined to stimulate Congressional interest in finding better ways to control tax expenditures. Two general and not mutually exclusive approaches have been suggested. One concentrates on limiting the overall level of tax expenditures, while the other focuses more on the purposes for which tax expenditures are used. Both approaches and their implications are dealt with in this chapter. The chapter also includes a brief review of the progress that has been made in the use of the budget process to control credit programs, and the lessons that can be learned from that experience in evaluating proposals to control tax expenditures.

No attempt is made to distinguish specifically between the kinds of changes in the budget process that can be made under existing authority and those that would require an amendment to the Budget Act. Section 301 of the Budget Act provides that concurrent resolutions on the budget may include "such other matters relating to the budget as may be appropriate to carry out the purposes of this Act." As the budget process has evolved, this authority has been used to experiment with changes such as the expanded use of reconciliation and development of a credit budget. As experience has developed with these new procedures, the Congress has become better able to decide which of them has worked well enough to merit actual embodiment in the Budget Act, and which require further development and modification. This same process of experiment and evolution would presumably be followed in any effort to impose further controls on tax expenditures.

THE IMPORTANCE OF CONTROLLING TAX EXPENDITURES

Tax expenditures have become one of the major ways in which the federal government allocates resources and affects private sector decisions. In 1967, the first year for which a tax expenditure budget was compiled, there were 50 items with a total revenue loss of $36.6 billion--4.4 percent of the gross national product (GNP). By fiscal year 1982, tax expenditures had grown to a total of $253.5 billion--8.4 percent of GNP (see Table 3). The most recent tax expenditure budget, included in Appendix A, shows 104 items totaling $273.1 billion for fiscal year 1983.

TABLE 3. TAX EXPENDITURE GROWTH, SELECTED CALENDAR YEARS 1967-1973 AND FISCAL YEARS 1975-1982[a]

	1967	1969	1971	1973	1975
Tax Expenditures					
Totals (in billions of dollars)	36.6	46.6	51.7	65.4	92.9
Percent of federal outlays	20.5	23.7	22.3	24.3	28.5
Percent of federal revenues	23.8	24.1	24.8	24.7	33.1
Percent of total federal "spending" (outlays plus tax expenditures)	18.8	20.3	19.7	21.0	22.3
Percent of GNP	4.4	4.8	4.6	4.7	6.3
Federal Outlays as a Percent of GNP	21.4	20.3	20.6	19.5	22.0
GNP (in billions of dollars)	777.3	910.6	1,031.5	1,252.0	1,479.9

(Continued)

a. Tax expenditures estimates were prepared only on a calendar year basis for the years 1967 to 1973. The estimates for calendar years 1967 to 1973 correspond roughly to fiscal years 1968 to 1974, and are thus compared to the GNP, outlay, and revenue figures for those fiscal years.

TABLE 3. (Continued)

	1977	1979	1981	1982
Tax Expenditures				
Totals (in billions of dollars)	113.5	149.8	228.6	253.5
Percent of federal outlays	28.2	30.3	34.6	34.6
Percent of federal revenues	31.7	32.3	37.9	40.8
Percent of total federal "spending" (outlays plus tax expenditures)	22.1	23.4	25.7	25.7
Percent of GNP	6.1	6.4	8.0	8.4
Federal Outlays as a Percent of GNP	21.6	20.9	23.1	24.2
GNP (in billions of dollars)	1,864.1	2,417.8	2,937.7	3,033.8

In many areas, the federal government exerts more influence through tax expenditures than it does through direct spending. The tax expenditures for general purpose fiscal assistance (mainly tax-exempt bonds and deductions for state and local taxes) are greater than direct federal outlays (mainly general revenue sharing), and tax expenditures for housing exceed outlays by more than four to one. Table 4 shows total tax expenditures and outlays by budget function for selected years between 1967 and 1987 and compares their growth. The tax expenditures for natural resources and environment, for example, grew by more than 800 percent between 1974 and 1981, while outlays for that purpose grew by just over 140 percent.

Tax expenditures add to the federal deficit in the same way that direct spending programs do. They also allocate resources and provide

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TABLE 4. CHANGE IN TAX EXPENDITURES AND OUTLAYS BY BUDGET FUNCTION, 1967-1987[a]

Budget Function	Amount (In billions of dollars) 1967	1974	1981	1987[b]	Percent Increase/Decrease 1967-1974	1974-1981	1981-1987	1967-1987
National Defense								
Tax expenditures	0.5	0.7	1.8	2.7	43	145	53	436
Outlays	78.8	77.8	159.7	303.5	-1	105	90	285
International Affairs								
Tax expenditures	0.3	1.7	2.7	4.5	481	61	66	1,453
Outlays	5.3	5.7	11.1	14.3	8	95	29	172
General Science, Space and Technology								
Tax expenditures	0.5	0.6	2.0	2.7	21	236	33	438
Outlays	5.5	4.0	6.4	8.1	-28	61	26	47
Energy								
Tax expenditures	1.6	3.0	6.6	10.7	84	124	63	570
Outlays	1.0	0.8	10.6	6.3	-17	1,171	-41	528
Natural Resources and Environment								
Tax expenditures	0.1	0.2	2.0	3.4	69	805	69	2,488
Outlays	3.0	5.7	13.8	11.6	89	143	-16	288
Agriculture								
Tax expenditures	0.8	1.3	1.4	1.9	63	10	32	137
Outlays	4.5	2.2	5.6	8.2	-51	151	46	80
Commerce and Housing Credit								
Tax expenditures	12.1	36.5	98.2	212.6	201	169	116	1,654
Outlays	4.3	3.9	4.0	5.7	-9	2	42	31
Transportation								
Tax expenditures	c	1.0	c	0.2	9,600	-96	386	1,600
Outlays	6.3	9.2	23.3	25.1	46	154	8	298
Community and Regional Development								
Tax expenditures	0.0	0.1	0.3	1.1	NA	276	250	NA
Outlays	1.4	4.1	9.3	9.1	199	124	-2	560
Education, Training, Employment and Social Services								
Tax expenditures	3.1	6.2	14.6	31.3	101	135	114	910
Outlays	7.6	12.3	30.6	30.9	62	148	8	331
Health								
Tax expenditures	2.6	5.1	19.9	35.3	95	294	77	1,257
Outlays	9.7	22.1	69.3	145.0	127	214	109	1,393

(Continued)

TABLE 4. (Continued)

Budget Function	Amount (In billions of dollars) 1967	1974	1981	1987b	Percent Increase/Decrease 1967-1974	1974-1981	1981-1987	1967-1987
Income Security								
Tax expenditures	9.7	13.8	52.0	89.2	42	278	71	822
Outlays	33.7	84.4	225.6	361.5	151	167	60	973
Veterans' Benefits and Services								
Tax expenditures	0.5	0.8	1.6	1.5	45	96	-3	177
Outlays	6.9	13.4	22.9	29.0	95	71	26	322
Administration of Justice								
Tax expenditures	0.0	0.0	0.0	0.0	NA	NA	NA	NA
Outlays	0.6	2.5	4.7	5.2	279	92	11	703
General Government								
Tax expenditures	0.0	c	0.1	0.1	NA	900	-20	NA
Outlays	1.6	3.2	4.7	5.2	109	46	11	237
General Purpose Fiscal Assistance								
Tax expenditures	4.7	11.2	25.3	42.0	139	127	66	797
Outlays	0.3	6.9	6.6	8.7	1,926	-4	31	2,451
Interest								
Tax expenditures	0.0	0.0	-0.1	0.4	NA	NA	-573	NA
Outlays	13.8	28.0	82.6	205.3	104	195	149	1,393
Allowances								
Tax expenditures	0.0	0.0	0.0	0.0	NA	NA	NA	NA
Outlays	0.0	0.0	0.0	11.6	NA	NA	NA	NA
Undistributed Offsetting Receipts								
Tax expenditures	0.0	0.0	0.0	0.0	NA	NA	NA	NA
Outlays	-5.5	-16.7	-30.3	-65.8	-205	-82	-117	-1,106
Total								
Tax expenditures	36.5	82.0	228.6	439.4	124	179	92	1,102
Outlays	178.8	269.6	660.5	1,130.5	51	145	71	532

NOTES: NA = not applicable.
Details may not add to totals because of rounding.

a. Tax expenditure estimates were prepared only on a calendar year basis for the years 1967 to 1973. The estimate for calendar year 1967 corresponds roughly to fiscal year 1968, and is therefore compared to the outlays for that year. These estimates reflect legislative and definitional changes in tax expenditures as well as inflation and economic growth.

b. The 1987 outlay estimates are from Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982).

c. Less than $50 million.

incentives and benefits in the same way. They are one of the ways by which the federal government plays a role in the economy and involves itself in the lives of its citizens.

Unlike direct spending programs, however, tax expenditures have low visibility in the budget process and are controlled in only a limited and indirect way. The Budget Act requires that a tax expenditure budget be compiled each year, but it is presented only for informational purposes. No direct budgetary decisions are based on it, and accordingly it receives relatively little attention. One consequence of this low visibility is that activities that may not have sufficient support to obtain federal funding through direct outlays may be funded through the back door by tax expenditures.

Tax expenditures show up as revenue losses, and thus have an important effect on the revenue totals that are included in Congressional budget resolutions. But they are treated for this purpose as simply another form of tax cut; they are not treated as alternatives to spending programs. There is an important distinction between general tax cuts that reduce taxes broadly across the board and tax expenditures that provide a tax cut only to those in certain specified circumstances or who act in certain specified ways. General tax cuts return resources to taxpayers to use in whatever way they see fit; tax expenditures return resources to taxpayers only if they do what the government would like them to do, or if they are thought deserving of special help. The present treatment of tax expenditures in the budget process blurs the distinction between these two ways of reducing taxes.

APPROACHES TO CONTROLLING TAX EXPENDITURES

Tax expenditures can be controlled by seeking to limit the total level of tax expenditures, the purposes for which tax expenditures are used, or both. Emphasizing control over the aggregate level of tax expenditures reflects an assumption that the major problem is excessive use of the tax code to achieve special, nonrevenue purposes. Reducing total tax expenditures is mainly a tax policy goal, prompted by the complexities, perceived inequities, and economic distortions that can result when the tax system is pushed beyond its basic function of raising revenues. Control over the aggregate level of tax expenditures is generally not necessary to achieve overall fiscal policy or revenue goals; the total revenue floor in the budget resolutions is usually sufficient for these purposes.

Emphasizing control over the purposes for which tax expenditures are used, on the other hand, reflects mainly a concern over budget priorities and the proper allocation of scarce budget resources to particular groups or activities. The desirability of either of these approaches, therefore, depends on the weight that is attached to these different goals and the likely effectiveness of each approach in achieving them.

Controlling Aggregate Tax Expenditures

The arithmetic total of all tax expenditures in fiscal year 1983 is estimated to be $273 billion, compared to CBO's most recent estimate of $633 billion for total revenues. The budget process can currently be used to require that total revenues be raised by, say, $10 billion, but under current procedures it cannot be used to require a $10 billion reduction in tax expenditures. As a result, the tax-writing committees are free to reach budgetary revenue-raising targets by any combination they choose of general increases in individual or corporate income taxes, reductions in tax expenditures, or increases in other taxes.[1] In terms of overall fiscal policy, it may make relatively little difference how it is done, since there are few systematic differences between the macroeconomic effects of changes in tax expenditures and other kinds of tax changes. In terms of tax policy, however--and the use of the tax system to achieve nontax purposes--it can make a big difference. Reducing some of the special exclusions, deductions, and exemptions in the tax code by reducing tax expenditures can help achieve tax policy goals of simplicity, equity, and neutrality. In general, tax expenditures make the tax code more complicated by adding provisions to which both taxpayers and the IRS must devote additional time. They make the code less equitable by treating differently taxpayers who are otherwise alike, and they make it less neutral by favoring some types of economic activity over others.

There is no guarantee that a limit on the aggregate total of tax expenditures would always serve these tax policy goals, since tax expenditures could be reduced in ways that make the tax system less simple, equitable, or neutral. Minimum tax plans, for example, tend to make the

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1. Section 301(d)(4) of the Budget Act requires that the Budget Committee reports on the first budget resolution contain "an allocation of the level of Federal revenues recommended in the concurrent resolution among the major sources of such revenues." The major sources include individual and corporate income taxes, social insurance taxes, excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts. Since this allocation does not appear in the budget resolution and is not voted on by the full Congress, it has no formal effect on tax committee decisions.

system more complicated, even though they reduce the revenue loss from tax expenditures. Tightening the eligibility rules for various tax expenditures can reduce the revenue loss, but usually at the cost of greater complexity and sometimes at the cost of some perceived unfairness, especially if people have made important decisions on the basis of the old rules. Cutbacks in tax expenditures benefiting one industry could make the tax system less neutral overall if similar tax expenditures in related industries were preserved.

To the extent that tax policy goals are furthered by limiting or reducing tax expenditures, the present system of placing a floor on total revenues can have a significant effect by itself, without the additional step of putting a ceiling on total tax expenditures. This is especially true if the goal of reducing tax rates, or avoiding rate increases, continues to have a high priority. Given a revenue floor, increases in tax expenditures crowd out opportunities for rate reductions or other forms of general across-the-board tax reductions, while reductions in tax expenditures make revenues available for more general kinds of tax cuts. The explicit competition between these two different approaches to tax reduction that is forced by a floor on revenues puts an extra burden of proof on the use of tax expenditures.

It is true, of course, that the burden of proof would be even greater with a ceiling that focused precisely on the aggregate total of tax expenditures. There are, however, definitional and measurement problems with this total that have led many to argue that it should not be used for budget control purposes. These problems can be largely avoided, however, if the controls are focused primarily on incremental changes to the tax expenditure total rather than on the total itself. Instead of saying, for example, that tax expenditures shall not exceed some total dollar amount in a particular year, or some percentage of GNP or total revenues, the budget resolution could specify that existing tax expenditures must be reduced by $10 billion, or that no more than $10 billion in new tax expenditures may be enacted. To see why this would minimize definitional and measurement issues, some discussion of these issues may be helpful.

<u>Definitional Issues</u>. Tax expenditures are defined in the Budget Act as the revenue losses attributable to provisions of the tax law that allow "a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[2] In general, tax expenditures are provisions that have some special purpose beyond simply collecting revenue in accordance with the

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2. The Budget Act of 1974, Sec. 3(a)(3).

standard tax policy goals of simplicity, equity, and neutrality. Provisions that are part of the normal structure of the tax code--general rate schedules and exemption levels, general rules on who is subject to tax and what accounting periods should be used, and deductions for the costs of earning taxable income--are not classified as tax expenditures.

Inevitably there are a few ambiguous cases. The deduction for two-earner married couples, for example, is treated as a tax expenditure.[3] But if the Congress had adopted a broader approach and allowed married couples to be taxed separately at the lower rates applicable to single persons, the change would probably have been regarded as a modification of the basic tax structure rather than as a tax expenditure. Despite such uncertainties at the borderline, there has been general agreement between the Congress and the Administration in the past on which provisions of the tax code are "special" enough to be termed tax expenditures. In the first three years after the Budget Act required the Administration to submit a formal tax expenditure budget (1975 to 1977), there were only three to four differences between the Congressional and Administration lists each year, while the lists were identical between 1978 and 1981.[4]

In February 1982, however, the tax expenditure budget submitted by the Reagan Administration omitted thirteen items that appear in the tax expenditure budget prepared for the Congress by the Joint Committee on Taxation, which is included as Appendix A of this report. Table 5 shows the items omitted from the Administration budget, and their estimated revenue effects for fiscal years 1982-1987. The Administration argued that the items omitted were not properly classified as tax expenditures.[5] This argument was countered in a later analysis by Professors Paul R. McDaniel and Stanley S. Surrey that relied on the legislative history of the

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3. This provision, enacted in 1981 to ease the so-called "marriage penalty," allows a deduction, when fully phased in in 1983, of 10 percent of the lower-earning spouse's wage and salary income up to $30,000 (maximum deduction of $3,000).

4. In 1975, the Congressional list contained four items not on the Administration's: deferral of income of controlled foreign corporations, Asset Depreciation Range (ADR), capital gains at death, and maximum tax on earned income. The maximum tax was added to the Administration's list in 1976, but the other three were still not included. Those three were omitted again in 1977.

5. <u>The Budget of the United States Government, Fiscal Year 1983,</u> Special Analysis G, "Tax Expenditures," pp. 5-8, 37 (February 1982).

TABLE 5. PROVISIONS INCLUDED IN THE CONGRESSIONAL TAX EXPENDITURE BUDGET BUT NOT IN THE ADMINISTRATION BUDGET (By fiscal year, in millions of dollars)

Tax Expenditure	1982	1983	1984	1985	1986	1987
Deferral of income of controlled foreign corporations[a]	520	560	605	655	705	760
Suspension of regulations relating to allocation under section 861 of research and experimental expenditures	55	120	60	b	b	b
Exclusion of payments in aid of construction of water, sewage, gas, and electric utilities[a]	30	45	70	75	80	75
Deductibility of patronage dividends and certain other items of cooperatives[a]	545	560	580	600	615	640
Exclusion of certain agricultural cost-sharing payments[a]	60	50	45	40	30	25
Depreciation on rental housing in excess of straight-line	565	705	820	885	940	990
Depreciation on buildings other than rental housing in excess of straight-line	330	400	465	525	590	660
Accelerated depreciation on equipment other than leased property	7,300	12,400	18,620	26,550	38,280	45,530
Reduced rates on the first $100,000 of corporate income[a]	6,605	7,125	8,065	8,740	8,660	8,630
Exclusion of scholarship and fellowship income[a]	465	415	375	395	410	435
Exclusion of employer-provided child care	b	10	25	55	85	120
Deduction for two-earner married couples	705	3,980	7,030	7,980	8,945	10,070
Exclusion of public assistance benefits[a]	445	430	430	440	455	470

SOURCES: For the Administration budget, The Budget of the United States Government for Fiscal Year 1983, Special Analysis G, "Tax Expenditures," Table G-2 (February 1982); for the Congressional budget, Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987 (March 8, 1982).

NOTE: The Administration includes the expiring general jobs credit in its budget while the Congressional budget omits it. The Administration estimates that the credit will increase tax expenditures by $65 million in 1982 and $5 million in 1983. Also, the Administration includes "Income of trusts to finance supplemental unemployment benefits," under the heading of "Exclusion of other employee benefits," which is estimated to increase tax expenditures by $20 million in fiscal years 1982 and 1983. The Congressional budget also omits this.

a. Listed in Table G-3, Special Analysis G, "Revenue Loss Estimates of Provisions Previously Designated 'Tax Expenditures'."

b. Less than $2.5 million.

Budget Act to argue that the Administration had departed from congressionally established guidelines in omitting such items from the list.[6]

As long as the tax expenditure budget is simply an informational document, as it is now, there is usually little objection to including items about which there is some uncertainty. If actual legislative decisions are to turn on whether an item is included or not, however, more strains may be placed on the classification process. If a budget resolution ceiling were to be placed on total tax expenditures, for example, questions could conceivably be raised about whether each item in the present tax expenditure budget is properly classified. Most of these issues could be bypassed, however, if the limits were focused just on incremental changes to the total. The only question then would be whether a bill or amendment currently under consideration added a new tax expenditure or increased or reduced an existing one.

Measurement Issues. Since tax expenditures are revenues the government does not collect, they can not be directly observed. Instead, they must be estimated, using a set of assumptions and estimating conventions. The revenue loss from each individual tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed. This is a good approximation of the revenue cost of each individual tax expenditure, and is consistent with the way costs are estimated for individual direct spending programs. The arithmetic total of all these individual tax expenditure estimates, however, is a less meaningful number than the total of outlays for all spending programs.

The major difficulties arise because of interactions with the standard deduction (zero bracket amount) and the progressive income tax rate structure. If several tax expenditures that take the form of personal deductions did not exist, revenue would be higher by less than the sum of the tax expenditures, since more people would take the standard deduction. If several tax expenditures that take the form of exclusions from income did not exist, more income would be taxed at higher marginal tax rates, so revenue would be higher by more than the sum of the tax expenditures.

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6. Paul R. McDaniel and Stanley S. Surrey, "Tax Expenditures: How To Identify Them; How To Control Them," Tax Notes (May 24, 1982), pp. 595-597.

This is spelled out in more detail in Chapter II of CBO's September 1981 report on tax expenditures.[7]

These interactions can be taken into account if a limited number of tax expenditures is being considered, but the calculation becomes increasingly more complicated as more items are included. Including all tax expenditures and taking into account all of the interactions would require constructing a wholly new tax system without tax expenditures. The higher revenues that such a system would produce, assuming no other changes in the tax system and no effects on the economy from the tax increases, could be characterized as the total revenue loss from tax expenditures. Because these are not realistic assumptions, however, the resulting number would be an artificial one. Furthermore, it would no longer be a useful estimate of the revenue loss from each individual tax expenditure, since there would be no way to assign the difference between the total and the sum of the parts to any one of the parts.

These problems with the aggregate number essentially fall away if the focus is shifted from controlling the total of tax expenditures to controlling incremental changes to that total. If a budget resolution specified that tax expenditures were to be increased or decreased by $5 billion, the only question would be whether the provisions reported out by the tax-writing committees had that effect. This is the kind of estimate on which the Congress relies all the time in considering tax legislation. It presents few unique measurement problems.

One related accounting problem would remain, however: the question of how to treat changes in overall tax rates or the standard deduction (zero bracket amount). A reduction in income tax rates would reduce the revenue loss from all tax expenditures that take the form of deductions, exemptions, or exclusions from income, since the revenue loss is measured by multiplying the amount excluded by the relevant marginal tax rate. Similarly, increases in the standard deduction would reduce the revenue loss from all tax expenditures that take the form of itemized deductions. Both of these changes tend to serve tax policy goals of improving simplicity, equity, and neutrality. This suggests that such changes should be scored as reductions in tax expenditures for budget purposes.[8]

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7. Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986 (September 1981), pp. 7-8.

8. Adopting such an accounting rule would, however, raise the question of whether all the exclusions, exemptions, and deductions in the tax

Such a rule might allow the Congress to increase specific tax expenditures after a rate cut or standard deduction increase had left room by reducing tax expenditures across the board. This would be unlikely, however, since the Congress would continue to be governed by an overall revenue floor. Rate cuts or standard deduction increases would reduce revenues toward that floor, and would normally leave little room for the additional revenue reductions that would result from increases in specific tax expenditures.

Conclusion. In short, controls on tax expenditures in the aggregate are quite feasible if they are focused on incremental changes to the totals. Such controls can help to achieve tax policy goals, but they are generally not needed to achieve fiscal policy goals.

Controlling the Purposes for Which Tax Expenditures Are Used

Under current procedures, control over specific tax expenditures is exclusively in the hands of the tax-writing committees. By establishing an overall revenue floor, the Budget Committees can exert some pressure on the tax-writing committees to reduce tax expenditures. As discussed in Chapter II, this procedure resulted in substantial cutbacks in tax expenditures this year in the Tax Equity and Fiscal Responsibility Act of 1982. But the decision about how to raise the required amount of revenue is left solely to the tax-writing committees. It need not be done by reducing tax expenditures.

Similarly, the authorization and appropriation committees have considerable discretion in deciding what program changes are needed to meet the outlay ceiling in budget resolutions. In the case of spending programs, however, that discretion is constrained by the procedure that breaks down the overall outlay ceiling into 19 separate budget functional categories, such as national defense, energy, agriculture, commerce and housing credit, income security, and so forth. The programs within these categories are then further broken down and allocated to the authorization and appropriation committees that have jurisdiction over them. Neither the budget functional categories nor the committee allocations are binding; they serve only as targets. But they enable the Congress as a whole to indicate what its broad priorities are with respect to the overall allocation of federal spending.

(Footnote 8. Continued)
expenditure budget meet the definition of a tax expenditure, a problem that is avoided if only the revenue effect of changes in specific tax expenditures is at issue.

Furthermore, while these targets are not binding, they are generally adhered to fairly closely. The current major exception is the appropriations committees, which have frequently departed from the budget functional targets, while still staying within their overall committee allocations. In addition, the process of reconciliation puts more teeth in committee allocations. Reconciliation bolsters the outlay ceiling in the budget resolution by requiring committees to cut spending by specific amounts by making changes in programs within their jurisdiction. Changes in specific programs are not required by reconciliation directives, but the options for program cuts actually available to the committees are usually so limited that their discretion is significantly constrained.

Tax expenditures can be broken down into separate budget functional categories according to their various purposes, just as is done for spending programs. Indeed, tax expenditure budgets have always been presented in this way, with refinements in recent years to make them correspond as closely as possible to the budget functional categories on the spending side. The most recent tax expenditure budget, included in Appendix A, takes the additional step of assigning each tax expenditure to a separate budget subfunction (energy supply and energy conservation within the energy function, for example), something that the CBO first did last year. Each CBO tax expenditures report since 1978 has also included an illustrative allocation of tax expenditures to committees with jurisdiction over analogous spending programs, a feature that is included in Appendix B of this report.

All this has been done solely for informational purposes, however; no actual legislative decisions are made on the basis of these breakdowns and allocations. If the Congress wanted to exercise control over tax expenditures that is analogous to the control that is exercised over spending programs, this information could be a starting point.

Argument for Controlling Tax Expenditures by Purpose. The argument for taking such a step is that tax expenditures are so close to spending programs in their effects on resource allocation that they ought to be subject to the same priority-setting process that is used for spending programs. Under current procedures, if the Congress as a whole has some preference as to how tax subsidies for various purposes should be allocated, there is no way of reflecting that preference, other than through ad hoc decisions on tax bills as they happen to come up for a vote. Less than 1 percent of total outlays is devoted to commerce and housing credit, for example, while that budget function includes more than 40 percent of total tax expenditures. This may represent the allocation that the Congress prefers, but the process as it now operates provides no way to decide that systematically.

The current process also provides no systematic way of avoiding duplication and overlap among spending programs and tax expenditures that serve similar purposes, or of forcing trade-offs among tax and spending programs to determine which is the most effective or least costly. For spending programs alone, the present system of grouping spending programs into budget functions facilitates these comparisons and trade-offs, even though the budget functions serve only as nonbinding targets. Duplication and overlap become more apparent when programs must be considered together, and increases in programs within a function tend to come at the expense of other programs within the same function. The exclusion of tax expenditures from these budget functional controls makes it more difficult to identify and pursue opportunities for efficiencies and cost savings.

If both spending programs and tax expenditures were considered together, the Congress could better determine whether there is avoidable overlap and duplication when, for example:

- Residential energy conservation is subsidized by tax credits from one agency and grants and loans from another;

- Construction of low- and moderate-income rental housing is subsidized by rent and interest subsidies from the Department of Housing and Urban Development and by tax subsidies in the form of accelerated depreciation, immediate write-off of construction period interest and taxes, tax-exempt bonds, and special treatment of capital gains;

- The Interior Department provides direct grants for historic preservation and helps to administer separate tax incentives for the same purpose;

- Both the targeted jobs tax credit and the Job Corps seek to provide jobs for hard-core unemployed youth; and,

- Both the Export-Import Bank and the Domestic International Sales Corporation (DISC) tax provisions subsidize U.S. exports.

If the goal is to control the use of tax expenditures to allocate resources, some system that requires them to be considered in conjunction with related direct expenditure and loan programs is necessary. And for the system to be meaningful, there must also be incentives to make trade-offs. Reductions in tax expenditures must be directly translatable into something that those involved in the process find desirable, and increases in tax expenditures must involve some costs.

Under current procedures, reductions in tax expenditures can provide benefits in the form of lower deficits and increased opportunities for rate reductions or other more general tax cuts. Increases in tax expenditures have corresponding costs, adding to the deficit and reducing opportunities for general tax cuts. Trade-offs of this kind can be achieved without involving any committees other than those with jurisdiction over taxes.

To go beyond this, however--to set up direct trade-offs between tax expenditures and related spending or loan programs--other committees with jurisdiction over those programs must be involved. In such an expanded system, reductions in tax expenditures could permit increases in related spending programs, and increases in tax expenditures could require reductions in related spending programs. The following sections describe some of the ways in which such a system might work, and analyze the arguments for and against such an extension of the budget process. The approach that is outlined is conceptually similar to the Canadian "envelope" system for controlling tax expenditures, which is described in more detail in the next chapter.

Involvement of Spending Committees. The obvious starting point for any system involving the spending committees in the consideration of tax expenditures would be to include a breakdown of tax expenditures by budget function in the budget resolution, and then allocate the tax expenditures in each function to the committees with jurisdiction over analogous spending programs.

A full-scale system might then require spending programs within the jurisdiction of the spending committees to be reduced whenever the tax committees approved a new or increased tax expenditure in the same category. Correspondingly, a spending committee could recommend to the tax committee that tax expenditures assigned to the spending committee be reduced and, if the tax committee agreed, spending programs within the spending committee's jurisdiction could be increased by the same amount.

There are two conceptual problems with such a system, however. First, not all tax expenditures fit neatly within the jurisdiction of a particular spending committee. The tax expenditures for accelerated depreciation, the investment tax credit, and capital gains, for example, provide incentives for a wide range of different types of investments. There are no truly comparable spending programs, so it is far from clear which spending committees, if any, should bear the costs of increases in such tax expenditures or benefit from their reduction.

Second, the Congress might prefer that the revenue from any reduction in tax expenditures be used to reduce the deficit or fund a more general tax cut rather than to increase spending. Similarly, the Congress might prefer that increases in tax expenditures be used to provide increased total resources for a particular purpose, to be financed through a higher deficit or increased taxes elsewhere.

These considerations suggest that any system for involving spending committees in the consideration of tax expenditures should be a fairly ad hoc one, at least at the outset. Decisions would have to be made on a case-by-case basis about whether, for example, a particular tax expenditure was analogous enough to existing or proposed spending programs to require a direct trade-off, and whether a reduction in a particular tax expenditure should be used to finance an increase in related spending programs, a general tax cut, or a reduction in the budget deficit.

The initial decisions on these issues could be made by the Budget Committees, subject to approval by the full House and Senate.[9] There are a variety of ways in which the Budget Committees could seek to involve the spending committees in selected decisions on tax expenditures, including the use of reconciliation, referral of new or increased tax expenditures to the spending committees, and recommendations from the spending committees for changes in existing tax expenditures. Experimentation with different procedures would be consistent with the Budget Committees' responsibility, as set out in the Budget Act, "to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays." (Sections 101 and 102) Some of the possibilities are described below.

Reconciliation. One mechanism for forcing such trade-offs could be the reconciliation process that the Congress now uses to reinforce budget resolutions by requiring committees to reduce outlays or increase revenues by specific amounts by changing programs and laws within their jurisdiction. A reconciliation directive could go jointly to the tax committees and the committees with jurisdiction over the spending programs in which cutbacks are sought. The committees involved could be given a target for total reduction in the deficit, with the distribution of that amount between

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9. Other possible initial decisionmakers include the House Committee on Rules or the House and Senate Parliamentarians. The kinds of decisions involved, however, would require judgments about issues of fiscal policy and resource allocation rather than the application of formal rules to particular circumstances. They are thus more like other decisions that the Budget Committees must make than they are like Rules Committee or Parliamentarian decisions.

reductions in direct spending and tax expenditures left to the committees involved.

This could begin with tax expenditures that are very closely related to spending programs. The exclusion from tax of Social Security benefits, railroad retirement benefits, workmen's compensation, veterans' disability compensation, and part of unemployment insurance benefits are tax expenditures that the Congress probably took into account to varying degrees in setting existing benefit levels. These tax expenditures could well be considered in conjunction with proposals to cut back spending on those programs. Instead of applying some form of across-the-board cutback or income test to Social Security or workmen's compensation benefits, for example, those benefits could be made subject to tax.

Given the inevitable difficulties in coordinating the activities of two different committees, such a procedure might begin with spending programs that are already within the jurisdiction of the tax committees. There were some precedents this year for trade-offs of this kind. The Tax Equity and Fiscal Responsibility Act of 1982 contained a provision authorizing payment of additional weeks of unemployment compensation benefits, to be financed by reducing the income levels below which unemployment compensation benefits are tax-free from $25,000 for joint returns and $20,000 for single returns to $18,000 and $12,000, respectively. Since the unemployment compensation program is under the jurisdiction of the tax committees, the offset could be handled with no jurisdictional problems. The Senate Budget Committee also considered this year a proposal that would have required the tax committees to achieve $40 billion in Social Security savings over the fiscal year 1983-1985 period either by increasing taxes or reducing benefits. Again, both the spending program and the taxes were within the jurisdiction of the tax committees.

Referral of New or Increased Tax Expenditures. Another way to involve the spending committees in the consideration of tax expenditures would be to require that all legislation providing for new or increased tax expenditures approved by the tax committees be referred to the committee or committees with jurisdiction over analogous spending programs.[10] Again, since some tax expenditures, like accelerated depreciation, are not

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10. The Rules of the House of Representatives already provide authority for the nontax committees to review tax issues on a less formal basis: "Each standing committee of the House shall have the function of reviewing and studying on a continuing basis the impact or probable impact of tax policies affecting subjects within its jurisdiction . . . ." (Rule X 2.(d))

closely related to any particular spending programs, this referral process would probably have to be done on a selective basis, with the initiative perhaps coming from the Budget Committees.

For any new or increased tax expenditures referred to them, the spending committees could recommend approval, approval with modifications, or disapproval. Its recommendation would then accompany the bill to the floor. This could be merely an advisory procedure, or it could go further, following the pattern of Section 401 of the Budget Act, which requires review by the appropriations committees of bills providing new spending authority for entitlement programs. Section 401 allows the appropriations committees to amend bills referred to them under this procedure, but only amendments limiting new spending authority are permitted, since the purpose of the section is to limit open-ended spending commitments. For the same reason, appropriations committee review of reductions in existing spending authority is not required. If the Congress wanted to use spending committee review of tax expenditures solely as a device to limit tax expenditures, this same pattern could be followed; the spending committees could be allowed to amend tax expenditure provisions referred to them, but only in ways that would limit the revenue loss, and reductions in existing tax expenditures would not have to be referred to the spending committees. If the Congress wanted to give this tax expenditure review even more bite, it could provide that spending committee approval of a new or increased tax expenditure would entail a corresponding reduction in that committee's spending allocation if the tax expenditure increase was ultimately adopted by the full Congress.

If, on the other hand, the Congress wanted to allow spending committees to recommend increases in tax expenditures, or to use the revenues raised by reductions in tax expenditures to fund spending programs within their jurisdiction, a procedure like that described below could be followed.

Recommendations by Spending Committees. The spending committees could be allowed to recommend to the tax committees that a tax expenditure included in the spending committee's allocation be reduced or eliminated, and if the tax committee agreed, the spending committee's spending allocation could be increased. Spending committees faced with the need to reduce spending on programs within their jurisdiction might recommend that tax expenditures allocated to them be reduced instead. The energy committee, for example, might recommend that the home insulation tax credit be reduced in order to provide additional funding for grant and loan programs for home insulation. The public works committee might recommend that tax-exempt industrial revenue bonds be limited in order to provide more funding for Economic Development Administration

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programs. The banking committee might recommend that the new tax provisions allowing more rapid depreciation for commercial and residential real property be scaled back in order to provide more funding for low- and moderate-income rental housing.

If, however, the Congress's main concern was to reduce the deficit or to free more resources for taxpayers' own use, it might prefer that any amount saved by reducing tax expenditures be used to cut the deficit or to fund general tax cuts instead of being used by the spending committees to fund alternative spending programs. The Budget Committees could perhaps act as the initial arbiters on this issue, with the final decision made by the full House and Senate.

Arguments For and Against Involving Spending Committees. The arguments for more direct involvement of the committees with jurisdiction over analogous spending and loan programs in the control of tax expenditures rely mainly on those committees' greater expertise in the related program areas. This expertise might enable them to give tax expenditure proposals a more critical evaluation. They could determine more readily whether a tax expenditure would duplicate or overlap with similar spending programs, and might be able to suggest ways of coordinating the administration of tax expenditures with that of similar spending programs. They might also help to prevent those who are unable to obtain federal assistance through grant or loan programs from making end runs around the budget process and obtaining it through tax expenditures.

The argument on the other side is that the spending committees have long-standing relationships with the beneficiaries of many of these programs and with the agencies that administer them. These relationships might lead the spending committees to act as advocates for the allocation of more resources to these areas, rather than as skeptical critics. They might welcome the opportunity afforded by tax expenditures to provide assistance to groups or causes they favor in a way that is less visible and less subject to budget controls. If a system for involving spending committees in the review of tax expenditures is to serve the goal of budgetary restraint, therefore, the expansion of tax expenditures must not be costless for them. The procedures outlined above would generally limit opportunities for cost-free increases in tax expenditures. Reconciliation has been used almost exclusively to cut rather than increase spending and tax expenditures. Approval by the spending committees of any new or increased tax expenditures referred to them could entail some costs if related spending programs in their jurisdiction were threatened with cutbacks if approval was granted. Recommendations by the spending committees for increases in tax expenditures could undermine the rationale for related spending programs within their jurisdiction by raising the